Finance and economics: Economics focus: Is this the end of sticky prices?

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Abstract:
Some say the Internet is ushering in a world in which prices change at the click of a mouse. And, they argue, the economy would run more efficiently as a result. Will the Internet really make prices more flexible? The answer depends on why prices now to fluctuate with every shift in supply and demand now.

Full Text:

Some say the Internet is ushering in a world in which prices change at the dick of a mouse. There will be plenty of exceptions

AS SHARES are bought and sold, the prices on trading screens flicker red and black. Most other prices are far less jumpy. Petrol-pump prices don't change every time the oil price moves, holiday prices and standard hotel rates are fixed for months, and doctors seldom alter their fees. Some claim the Internet could change all that. Prices could flick at the click of a computer mouse. And, they argue, the economy would run more efficiently as a result.

Will the Internet really make prices more flexible? The answer depends on why prices fail to fluctuate with every shift in supply and demand now. Simply put, prices change only when the cost of leaving them unchanged becomes bigger than the expense of adjusting them. In financial markets, prices move all the time because the cost of quoting the "wrong" price can be huge. If market makers failed to raise prices when they were too low, for instance, they would make hefty losses because they would be obliged to sell unlimited amounts of securities on the cheap. And on a market stall, a fruit trader who didn't lower prices when they were too high would have to throw away unsold produce at the end of the day.

The Internet is unlikely to increase the cost of leaving prices unchanged. It will not make petrol perishable or make it more expensive to sell holidays at less than cost. But it will make it cheaper to change some prices. Electronic price-tags can be altered almost costlessly. Digital holiday brochures do not need reprinting. And the Internet makes finding out and comparing prices much easier. Rates for hotel rooms in Honolulu can now be checked from a laptop in London. That, some argue, will make booking a room more like buying shares, where investors plump for the broker quoting the best price, which changes all the time.

For many goods, they may be right. Most people would buy the latest Madonna CD, John Grisham thriller or even their electricity from the supplier with the lowest prices; who the retailer is barely matters. In those cases, keener competition may make prices adjust faster to swings in supply and demand. But the Internet is unlikely to make all prices more flexible, especially because it may often be more efficient for prices to change irregularly. Sticky prices are likely to survive in at least three cases: when the quality of a product is hard to assess; when consumers dislike frequent price changes; and when a market is dominated by a few firms that are wary of altering the amount they charge.

First, consider firms which compete on quality as well as price. Consumers often find it difficult to judge how good their product is; and making a mistake may be costly. It can be hard to know how good a hotel is until you've stayed there; and a sleepless night in a lousy hotel before a big meeting is best avoided. So customers who have stayed in a hotel they like may return, even if rivals of the same standard are offering cheaper rates- especially as on a repeat visit they may know which side of the hotel is less noisy, and the manager may remember to book them a good table for dinner.

But if prices have risen since their last visit, they may reconsider. This may be why hotels that are nearly full rarely raise their rates for the night, as you might otherwise have expected. And half-empty hotels may be reluctant to cut room prices, because raising them again when demand recovers could drive away repeat customers as well as bargain hunters. That in turn could hurt their reputationand hence how much new business they are likely to get (they may, of course, have different seasonal or weekend rates). Similarly, doctors are unlikely to cut their fees when demand is slack during the summer or raise them when patients flock to them in winter.

Firms may also keep prices stable because they are providing insurance to customers who dislike volatile prices, especially when buying expensive things. Customers choosing a holiday do not want prices to change while they are deciding where to go; and they will be loth to book months in advance if the price of their holiday might fall sharply a few days later.

Companies rarely fix both prices and quantities, though, because it would make their profits too risky. So consumers who value fixed prices usually have to accept that firms may ration access to the good. Thus a travel agency may guarantee the price of a holiday, but with the proviso that the charter flight can be cancelled if not enough people book.

When fixing is fine That may seem less efficient than deals where the desired quantity is always available and access is rationed by price, but perhaps not. Fixed-price contracts give firms, which generally know more about market conditions than consumers, an incentive to be truthful rather than misrepresent the levels of supply and demand. If doctors did not fix their fees, they would have an incentive to say they were in huge demand-and that you needed to see them urgently. And a hotel that varied its prices a lot would have an incentive to pretend it was nearly full, to get customers to pay more. In this way, sticky prices can improve the flow of information about the market.

Even when assessing quality is straightforward and consumers have no reason to object to flexible prices, prices may stay sticky if competition is lacking. Take petrol, which is sold by a handful of big companies. As there are only a few providers in the retail market, each will consider its rivals' likely response before changing prices. A petrol company may thus be reluctant to raise prices if it expects its rivals to try to steal a march on it by leaving their prices unchanged. And it may also be wary of cutting prices, because it may gain nothing but earn lower profits if others follow suit. If each firm reasons in this way, prices may change infrequently.

When prices are fixed for too long, of course, supply and demand may get badly out of kilter. In that case, hotels, holiday companies, doctors, petrol retailers and the like will decide to alter their rates, fees and so on. In times of high inflation, too, prices may change more often. But the Internet is unlikely to spell the end for sticky prices.

[Illustration]